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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 607

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF ROCHESTER,

Petitioner,

—*v.*—

PHILLIP J. McNELLIS, as Trustee of Donald S. Potter, Bankrupt, et al,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

ROBINSON, WILLIAMS, BROWN, ROBINSON AND ANGELOFF
(CARL ANGELOFF, *of Counsel*)
Attorneys for Petitioner
700 Reynolds Arcade Building
Rochester, New York 14614
454-1990

THE DAILY RECORD CORP. — ROCHESTER, N. Y.

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Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

Robinson, Williams, Brown, Robinson and Angeloff, on behalf of Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above case on July 27, 1966.

OPINIONS BELOW

Copies of the Opinion of Justice Ringrose for a Special Term of the New York State Supreme Court and order entered pursuant thereto, the Order dismissing respondents' appeal from Justice Ringrose's decision to the Appellate Division of the New York State Supreme Court for the Fourth Judicial Department, the Memorandum Decision and Order of Judge Brennan for the Federal District Court, and the Opinion of Feinberg, J. for the United States Court of

Appeals for the Second Circuit and that Court's Judgment of reversal are appended to this petition in the Appendix at pp. 1a to 36a.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was made and entered on the 27th day of July, 1966, and a copy thereof is appended to this petition in the Appendix at pp. 25a to 36a. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTIONS PRESENTED

The petition places in question the determination of the United States Court of Appeals for the Second Circuit that the denial of a motion for leave to serve a supplemental complaint in a New York State Supreme Court action was not on the merits and as such was not entitled to res judicata effect in a later action brought in the Federal District Court on the same cause of action, the Federal District Court having held that the denial of leave to serve the supplemental complaint in the State Court was on the merits and entitled to res judicata effect. The Questions presented are:

(1) Whether the denial of respondents' motion to serve a supplemental complaint by Justice Ringrose in the State Court action was "on the merits"?

(2) If the denial of that motion was on the merits, whether the Memorandum decision and Order of Judge Brennan dismissing a complaint on the same cause of action in the Federal District Court should have been affirmed by the United States Court of Appeals for the Second Circuit?

(3) Whether the reversal of Judge Brennan's Order by the United States Court of Appeals for the Second Circuit constituted a denial of Full Faith & Credit by a Federal Court to a State Court Judgment?

(4) Whether the decision of the United States Court of Appeals for the Second Circuit that the denial of the motion for leave to serve the supplemental complaint by Justice Ringrose in the State Court action was not "on the merits" constituted a decision by a Circuit Court of Appeals on an important question of local law in conflict with applicable local decisions?

STATEMENT OF FACTS

On April 27, 1962, First Federal Savings and Loan Association of Rochester, the Appellee below and Petitioner herein, granted a mortgage to the Randolph House Motor Hotel Corp. At the time of closing, a mortgage origination fee in the amount of $124,000.00 was paid to Petitioner. In February, May and June of 1963, the Randolph House Motor Hotel Corp., Donald S. Potter, the sole shareholder of the Randolph House Motor Hotel Corp., and the Potter Securities Corp., a corporation which owned all of the capital stock of the Randolph House Motor Hotel Corp., respectively, were adjudicated bankrupts. On or about November 21, 1963, the trustees for the bankrupts (hereinafter called Respondents) commenced an action in the New York Supreme Court to set aside the payment of the mortgage origination fee and to recover double damages on the ground that the fee was usurious and a fraudulent conveyance. Shortly thereafter, Respondents sought leave to serve a supplemental complaint which alleged that three subsequent mortgage payments were also usurious and fraudulent conveyances. Petitioner and Respondents moved for summary judgment (Respondents' motion being withdrawn before decision). The New York State Supreme Court per Justice Ringrose disposed of these and other motions by decision dated June 19, 1964. Justice Ringrose, rejecting Respondents' claims of usury and fraudulent conveyance, granted Petitioner's motion for summary judgment. In addition,

Justice Ringrose denied Respondents' motion to serve the supplemental complaint on the ground that the decision announced with respect to the original complaint precluded any recovery on the ground of usury and fraudulent conveyance on the issues raised by the supplemental complaint.

Respondents filed a Notice of Appeal from this decision to the Appellate Division for the Fourth Department. In November of 1965, Petitioner moved to dismiss this Appeal on the ground that Respondents had failed to seasonably file and serve the papers on Appeal and on December 2, 1965, the Appellate Division granted Petitioner's motion and entered an Order dismissing the Appeal. Significantly, this Order of the Appellate Division finally closed the doors of the Courts of New York to Respondents both on the issues decided by the summary judgment granted to Petitioner and also on the propriety of the trial court's dismissal of Respondents' motion to serve the supplemental complaint.

On May 12, 1964 while the State Court action was pending Respondents began an action in the Federal District Court for the Northern District of New York making allegations so similar to the State Court complaint and supplemental complaint as to make these complaints indistinguishable. This action was stayed pending the outcome of the State Court action. After Justice Ringrose's decision, the entry of the Order rendered pursuant to that decision, and the dismissal of Respondents' Appeal to the Appellate Division, the Federal Court action was continued. Petitioner moved for summary judgment principally on the ground that the Federal complaint presented issues already finally adjudicated in the State Court action and that the defense of res judicata therefore applied. Petitioner contended that the matter contained in the supplemenary complaint could not constitute an independent basis for decision in the Federal action since the issues raised in the supplementary complaint were

naturally a part of the single transaction or occurrence which was the basis of the original State Court complaint and that the issues raised in the supplementary complaint were therefore not only necessarily litigated in the State Court action, but also were in fact litigated in the State Court action in light of Justice Ringrose's denial of plaintiff's motion to serve the supplemental complaint "In view of the decision above announced". Judge Brennan heard arguments on the motion on June 8, 1964 and, in a decision rendered January 14, 1966, granted Petitioner's motion for summary judgment. In rejecting Respondents' contention that the supplemental complaint raised issues not litigated in the State Court, Judge Brennan stated that:

> "If, as the State Court has held, the usury statutes do not apply, it is difficult to understand how the payments alleged to have been made upon the valid mortgage instrument held by the defendant would be invalidated. The alleged fact that the payments were made by Donald Potter might have some relevancy to plaintiff's principal contention that the corporations were mere dummies through which he acted but would seem to have no probative effect upon the validity of the instrument itself. The above is not the full measure of plaintiff's difficulty in regard to this contention."

Continuing, Judge Brennan correctly noted that *"The right to recover, asserted by the plaintiffs in the State Court action, rests upon the same factual and legal bases."* .Emphasizing that the Federal Court could on a motion for summary judgment consider whether the principle of res judicata applied to matters outside of the pleadings, Judge Brennan concluded that the defense of res judicata applied and commented that:

> "No question is raised but that the State Court had jurisdiction in the matter of the cause of action above referred to, as instituted and decided therein. Reported legal precedents appear to be unanimous in holding that *an adjudication of a controverted matter by a competent State Court forecloses further litigation as to issues actually raised and as to relevant issues which could have been litigated therein.*"

Respondents took an appeal from Judge Brennan's decision to the United States Court of Appeals for the Second Circuit on the ground that Justice Ringrose's denial of their request to serve the supplemental complaint did not constitute an adjudication on the merits and as such was not entitled to res judicata effect before the Federal District Court. The Second Circuit reversed that part of Judge Brennan's decision which gave res judicata effect to Justice Ringrose's disposition of the fraudulent conveyance allegations raised in the supplemental complaint. Two basic reasons were advanced by the Second Circuit in support of their decision: (1) that the allegations in the supplemental complaint constituted a separate and distinct cause of action from those contained in the original complaint, and (2) that Justice Ringrose's disposition of plaintiff's motion to serve the supplemental complaint was not an adjudication on the merits and was therefore not res judicata to the subsequent litigation of that point in the Federal District Court.

REASONS FOR GRANTING WRIT

(A) SUMMARY

It is petitioner's contention (1) that the Second Circuit misapplied prevailing principles of New York law in holding that Justice Ringrose's denial of the motion to serve the supplemental complaint on a motion for summary judgment was not on the merits, (2) that the language contained in the State Court decision leaves no doubt that the denial of the motion to serve the supplemental complaint was on the merits, (3) that the decision of the Federal District Court according the State Court's denial of the motion to serve the supplemental complaint res judicata effect should have been affirmed by the Second Circuit, and (4) that the failure of the Second Circuit to so hold (a) will subject Petitioner to further illegal and vexatious litigation, (b) constitutes a de-

cision by the Second Circuit on an important state question in conflict with the clear decision of the State Court and applicable state law, (c) is a clear departure from the accepted and usual course of judicial proceedings insofar as the trustee in bankruptcy is afforded an unfair opportunity to re-litigate in Federal Court a question finally settled in a State Court, and (d) violates the mandatory requirements of the Constitution and Statutes of the United States that a final judgment of a State Court on the merits be accorded Full Faith and Credit in any subsequent suit on that judgment in a Federal Court.

(B) ARGUMENT

When New York's Justice Ringrose prefaced the dispository paragraph of his decision with the statement "In view of the decision above announced", he could only have intended his dismissal of Respondents' motion to serve the supplemental complaint to be final and on the merits. The original complaint raised the question of the propriety of the mortgage origination fee on two counts: (1) fraudulent conveyance, and (2) usury. Respondents' State Court Complaint admitted that Donald S. Potter was the sole shareholder of Randolph House Motor Hotel Corp. Both parties moved for summary judgment (Respondents' motion later being withdrawn) and Respondents also moved the Court for permission to serve a supplemental complaint containing a so-called "third cause of action" to set aside three subsequent payments on the mortgage as fraudulent conveyances. Thus the State Court had before it both the motions for summary judgment and the motion for permission to serve the supplemental complaint prior to reaching its decision. The Court granted Petitioner's motion for summary judgment, which was addressed to both complaints and held that the mortgage was not usurious and that the mortgage origination fee did not constitute a fraudulent

conveyance. In reaching this decision the Court dwelled at length upon the relationship of Donald S. Potter to the Randolph House Motor Hotel Corp.

In making this adjudication the Court, of course, had before it the supplemental complaint. That complaint was based upon the theory that three mortgage payments were made by Donald S. Potter in his individual capacity and as such were fraudulent conveyances with respect to his individual creditors. In writing that Potter must be deemed to stand in the shoes of the corporation with regard to the usury allegation, it is inconceivable that the State Court was not apprised of the fact that this finding would be conclusive to the merits of the fraudulent conveyance theory raised both in the original and supplemental complaint. If the mortgage was not usurious and secured a valid indebtedness and in addition, if the business activities of Donald S. Potter and the Randolph House Motor Hotel Corp, were indistinguishable, there could be no question that a payment of a part of the indebtedness secured by the mortgage, whether the mortgage origination fee or the subsequent payments, was for a "fair consideration" and as such not subject to attack as fraudulent conveyances. See *Lehrenkrauss* v. *Bonnell,* 199 N. Y. 240 (1910). Whether viewed from the point of view of Donald S. Potter or the Randolph House Motor Hotel Corp., the mortgage origination fee and the three subsequent payments produced the same beneficial result, i.e., Petitioner, First Federal Savings and Loan Association, was induced by these payments to grant the mortgage and forebear from foreclosing on the premises in order to pay the principal indebtedness. This forebearance on the part of Petitioner was obviously of equal benefit to both Donald S. Potter and the Randolph House Motor Hotel Corp. Potter's sole ownership and domination of the corporation made it perfectly natural that he pay the corpora-

tion's debt, if in fact he did so. This line of reasoning is made even more persuasive in our case by the admission contained in paragraph 14 of the original State Court complaint that "no capital was paid in to Randolph House Motor Hotel Corp. by Donald S. Potter for the issuance of its stock". The State Court's denial of the motion to serve the supplemental complaint "In view of the decision above announced" must under the foregoing facts and circumstances have been intended as a final adjudication on the merits of the issues raised in the supplemental complaint.

The complaint submitted by Respondents to the Federal District Court was substantially a copy of the complaint which had been considered by the State Court. With the exception of paragraph 10 which differs in each complaint with respect to an immaterial allegation and paragraphs 13 and 19 which set forth the same allegations in slightly different language, the first 27 paragraphs of each complaint are identical. These paragraphs set forth the venue of the action and the bankruptcy-adjudication of the Respondents. In addition, allegations with respect to the individual Respondents utilizing the corporate Respondents as dummies to facilitate business operations are set forth. The remainder of the Federal complaint (paragraphs 28-42) and the State Court complaint (paragraphs 28-39) describe the mortgage financing obtained by Respondents from Petitioner, the payment of the $124,000.00 mortgage origination fee, and the payment of $55,144.00 in three mortgage payments to Petitioner. Allegations with respect to the usurious nature of these payments and the insolvency of the Respondents are also set forth in these paragraphs. In each complaint (paragraphs 41 and 42 of the Federal Complaint and paragraphs 32-34 and 37 of the State Complaint) the Respondents set forth an identical legal basis for their claims, namely, the violation of Section 380(e) of the New York Banking Law (the usury statute), and the violation of

Article 10 of the New York Debtor and Creditor Law and Section 67(d) of the Federal Bankruptcy Act (the fraudulent conveyance statutes). Finally, the prayer for relief in each complaint is identical, i.e., double damages for the alleged payment of a usurious mortgage origination fee and the return of the three mortgage payments on the ground that their payment allegedly violated the fraudulent conveyance statute. Confronted with a Federal Complaint which was virtually identical to the State Court Complaint with respect to both the factual allegations and the legal basis of recovery, the Federal District Court correctly concluded that the principle of res judicata prevented Respondents from re-litigating their claim in Federal Court. Significantly, the Federal District Court recognized that the State Court's disposition of the motion for leave to serve the supplemental complaint had been on the merits and was accordingly within the doctrine of res judicata. The Second Circuit sought to circumvent the thrust of this reasoning by stating that the allegations of the supplemental complaint constituted a separate cause of action and that Justice Rigrose's disposition of the motion to serve the supplemental complaint was not on the merits. This, however, is an erroneous interpretation of Rule 5013 of the C. P. L. R. Rule 5013 provides that:

> "A judgment dismissing a cause of action before the close of the proponent's evidence is not a dismissal on the merits unless it specifies otherwise, but a judgment dismissing a cause of action after the close of the proponent's evidence is a dismissal on the merits unless it specifies otherwise."

The determinative issues decided in the State Court were the freedom of the mortgage indebtedness from the taint of usury and the fact that the granting of the valid mortgage to Respondents by Petitioner constituted fair consideration not only for the mortgage origination fee but also for all subsequent payments on the mortgage which therefore precluded

any allegations of fraudulent conveyance with respect to those payments. There can thus be no question that the motion for summary judgment and the motion for leave to serve a supplemental complaint were adjudicated after the close of the proponent's evidence and were therefore on the merits. *Linton* v. *Perry Knitting Co.*, 295 N. Y. 14 (1945) considered a similar situation. In the first action, defendant moved to dismiss the complaint on the ground that the cause of action alleged therein was barred by the Statute of Limitations and that the Workmen's Compensation Law of New York provided the exclusive remedy of the plaintiff and liability of the defendant. Defendant's motion was granted and the complaint was dismissed. A second action was thereafter commenced between the same parties and ostensibly on the same cause of action. Defendant's motion to dismiss the complaint was denied by a Special Term of the Supreme Court. The Appellate Division reversed and granted the motion. On appeal, the New York Court of Appeals affirmed stating that:

> " . . . even if the judgment in the earlier action was not a judgment on the merits — a point that we do not decide . . . The former judgment was a final determination that for either of two legal reasons the allegations of the earlier complaint were without more quite ineffectual. Such a determination, whether right or wrong, is a bar to another action for the same cause unless the defects or omissions adjudged to be present in the one action are corrected . . . The complaint now before us is virtually a copy of its predecessor. Hence dismissal of the present action was validly directed . . . " (17)

In the case at bar, the identity of the State and Federal complaints as described above leaves no question that the supplemental complaint was "virtually a copy of its predecessor." Justice Ringrose's denial of plaintiff's motion for leave to serve the supplemental complaint "In view of the decision above announced", is a clear indication that the supplemental complaint suffered from the same defects

found in the original complaint. This was an even stronger case than *Linton* insofar as the denial of leave to serve the supplemental complaint was also on the merits. The evidence of both parties was before the Court in the form of numerous affidavits and legal memoranda. It is of great significance that both parties moved for summary judgment. The later withdrawal of Respondents' motion could only have been intended to muddy the waters with regard to the question of whether the Court had reached "the merits" in the event the Petitioner's motion for summary judgment was granted. The Court of Appeals again considered this problem in *Flynn* v. *Sinclair Oil Corp.*, 20 A. D. 2d 636 (1st Dept. 1964). The first action was based upon the alleged negligence of an oil burner installer in repairing a stairway and railing previously damaged by it. That action was dismissed on the ground that it failed to state a cause of action. No appeal was taken from this dismissal. Another complaint was served which in essence raised the same claim for damages and added certain allegations concerning the continued fuel service by defendant. In addition plaintiff moved to add another defendant. Defendants cross-moved to dismiss the complaint. Special Term denied defendants' motion and permitted plaintiff to add the new defendant. The Appellate Division reversed and granted defendants' motion to dsimss the complaint on the ground that:

> "... plaintiff's complaint is virtually identical to one previously dismissed for failure to state a cause of action. No appeal was taken from that dismissal at Special Term. Accordingly, this second cause is barred on the ground of res judicata, and the complaint should have been dismissed ..." (636-37)

On appeal, the Court of Appeals affirmed without opinion (14 N. Y. 2d 853, (1964)). Significantly, in our situation, as in both the *Linton* and *Flynn* cases, no appeal was seasonably taken from Justice Ringrose's decision. In fact, the Appellate Division for the Fourth Judicial Department

granted petitioner's motion to dismiss respondent's appeal for failure to prosecute. Though Justice Ringrose's disposition of the motion to serve the supplemental complaint was on the merits, respondent's failure to prosecute their appeal precluded them from further litigating the point in the State Courts. Finally, it should be noted that Justice Ringrose's decision was consistent with the prevailing rules of New York Civil Practice regarding the propriety of permitting service of a supplemental pleading. A leading commentator has stated the rule as follows:

> ". . . leave to serve a supplemental pleading should be denied if there clearly is no need for an additional pleading as would be the *case when new facts can be established under the original pleading* . . . The delay and added effort that result from the granting of leave to serve a supplemental pleading and the service of a response to the supplemental pleading are not justified *if the material is unnecessary.*" (emphasis added)
>
> 3 Weinstein, Korn & Miller, *New York Civil Practice,* Para. 3025.18 at 30-454, 30-455.

In our situation, the merits of the supplemental complaint were reached in the Court's disposition of the original complaint and Justice Ringrose's denial of the motion to serve the supplemental complaint was simply the manifestation of his opinion that the supplemental complaint raised no new issues of fact or law. Since it is impossible to determine any other reason whatever for the State Court dismissal, especially in view of the language used in the decision, the decision in the State Court must have been a decision on the merits. The following New York cases support this procedural interpretation.

> (1) *Keller* v. *Greyhound Corp.*, 41 Misc. 2d 255 (Sp. T. Queens 1963): "It is recognized that ordinarily upon a motion such as this (i.e. to serve the supplemental pleading) the court will not concern itself with the sufficiency of the proposed pleading . . . and further that subdivision (b) of rule 3025 of the Civil Practice Law

and Rules provides that leave to serve supplemental pleadings 'shall be freely given'. However, where the insufficiency of the proposed pleading is clear, and free from doubt as a matter of law, it would serve no useful purpose to grant leave to serve a supplemental pleading. Leave to serve a supplemental pleading, under such circumstances, does not benefit the plaintiff and results only in wasting the time of the trial court and causing unnecessary expense in the administration of justice." (256)

(2) *Goldstock* v. *Kramer,* 6 Misc. 2d 8 (Sp. T. Bronx 1957): On motion for leave to serve supplemental pleading setting up a defense, the Court stated: "I recognize that, usually, the legal merits of a proposed defense would not be passed upon on an application for leave to interpose it . . . That would normally await a subsequent direct attack. But, where — as I think is the case here — the new pleading is so patently unnecessary and so plainly insufficient, I see no reason to allow it and thus to require a motion to strike which can but be granted thus leaving the pleadings as they were . . ." (9)

(3) *Coucounas* v. *Coucounas,* 33 Misc. 2d 559 (Sp. T. Kings 1962): "While under normal circumstances, on a motion to amend, a court will not examine into and determine the merits of a proposed amended pleading, it must deny such application if the pleading is palpably deficient." (560)

The refusal of the Circuit Court of Appeals for the Second Circuit to give recognition to the foregoing authority and to conclude that Justice Ringrose's denial of the motion to serve the supplemental complaint was on the merits constitutes a failure on the part of that court to give a State Judgment the Full Faith and Credit mandated by the Constitution of the United States and implementing statutes. See:

(1) *Mills* v. *Duryee,* 7 Cranch (11 U.S.) 481 (1813)

(2) *Huron Holding Corp.* v. *Lincoln Mine Operating Co.,* 312 U.S. 183 (1941)

(3) *Davis* v. *Davis,* 305 U.S. 32 (1938)

(4) *American Surety Co.* v. *Baldwin*, 287 U.S. 156 (1932)

(5) Ehrenzweig, *Conflict of Laws* (1962) sec. 47 at 166-167

In addition under either State or Federal Law there is no question that a proper finding by the Second Circuit in regard to Justice Ringrose reaching the merits on his denial of the motion to serve the supplemental complaint would have necessitated their affirmance of Judge Brennan's District Court decision on the ground of res judicata.

See:

(1) *United States* v. *Munsingwear, Inc.*, 340 U.S. 36, 38 (1950)

(2) *Angel* v. *Bullington*, 330 U.S. 183 (1947)

(3) *Bannon* v. *Bannon*, 270 N.Y. 484 (1936)

(4) *DeCosse* v. *Turner & Blanchard, Inc.*, 267 N.Y. 207 (1935)

(5) *Gramm* v. *Lincoln*, 257 F. 2d 250 (9th Cir. 1958)

(6) *Heisner* v. *Woodruff*, 327 U.S. 726 (1946)

(7) *Kaufman* v. *Shoenberg*, 154 F. Supp 64 (D. Del. 1954)

(8) *Oklahoma Packing Co.* v. *Oklahoma Gas & Electric Co.*, 309 U.S. 4 (1939)

(9) *Reich* v. *Cochran*, 151 N.Y. 122 (1896)

(10) *Riley* v. *Southern Transp. Co.*, 278 App. Div. 605 (3rd Dept. 1951)

(11) *Schuylkill Fuel Corp.* v. *B. & C. Nieberg Realty Corp.*, 250 N.Y. 304 (1929)

(12) *Smith* v. *Kirkpatrick*, 305 N.Y. 66 (1953)

(13) *Williamson* v. *Columbia Gas & Electric Corp.*, 186 F. 2d 464 (3rd Cir. 1950), cert. denied, 341 U.S. 921 (1951)

Finally, it is of crucial importance to recognize that the misapplication of State law, the obvious misconstruction of

a prior State decision, and the refusal to accept a prior final determination of a State Court by the Circuit Court of Appeals in this case is of great and recurring significance in the administration of the Federal Bankruptcy Laws. The important nature of these issues has already been recognized by this court in *Heisner* v. *Woodruff*, 327 U.S. 726 (1946). The policy promulgated in *Heisner* by Chief Justice Stone that the unsuccessful litigation of an issue outside of the Federal Courts by a trustee in bankruptcy precludes him from later re-litigating that point in a Federal Court stands to be circumvented by the Circuit Court's unreasonable interpretation of the prior State decision and State Law. The trustee in bankruptcy is not entitled to preferential treatment in order to permit him a chance to re-litigate the same issues in Federal Court. The trustee's election to litigate in a State Court should bind him in every way to that Court's determination and preclude re-litigation of the same cause of action in Federal Court. The serious questions of public policy involved herein and the effect of the decision below, if unreversed, upon the historic division of responsibility, at the option of the trustee in bankruptcy, between the State and Federal Courts in the administration of the Bankruptcy Laws, makes this case a peculiarly appropriate one for the exercise of this Court's discretionary jurisdiction.

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBINSON, WILLIAMS, BROWN,
ROBINSON AND ANGELOFF
(CARL ANGELOFF, *of Counsel*)
Attorneys for Petitioner
700 Reynolds Arcade Building
Rochester, New York 14614

454-1990